Economics and Sociology
Occasional Paper No. 1584

**RURAL FINANCE IN THE PHILIPPINES:
AN UPDATE**

by

Richard L. Meyer

May, 1989

Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
Columbus, Ohio
43210

PREFACE

This publication is prepared under a collaborative research project concerning rural finance in the Philippines. The principal collaborating institutions are the Philippine Institute for Development Studies (PIDS), the Agricultural Credit Policy Council (ACPC), and the International Rice Research Institute (IRRI). OSU participation is funded by the USAID Mission in the Philippines and the Bureau of Science and Technology, AID, Washington. The views expressed in these publications are those of the authors and may not be shared by any of the collaborating or sponsoring institutions.

RURAL FINANCE IN THE PHILIPPINES: AN UPDATE

Richard L. Meyer[1]

The purpose of this paper is to provide a brief update on major developments in rural finance in the Philippines, and to identify priority issues that remain in the development of sound, self-sustaining rural financial markets in the country. It is written as an update to my earlier paper "Rural Finance in the Philippines: Recent Changes and Priority Issues" prepared in June 1987. In that paper, it was noted that the environment for the reform of rural financial markets had substantially improved compared to the situation of just a few months earlier. Since then, a number of favorable developments have occurred, but there are also some troubling signs. The formal elements of the rural financial system still have a long way to go before we can be assured that a sound system is really in the process of being developed. Furthermore, there is still much to be learned about the informal system which continues to be the chief source of financial services for the poorest rural households.

[1]I am indebted to several people who provided information used to develop the ideas presented in this paper, especially Emmanuel Esguerra, Mario Lamberte, Gilbert Llanto, and Bruce Tolentino. The usual disclaimers apply.

KEY DEVELOPMENTS

Major Financial Reforms

One of the most important trends in recent months has been the change noted in Central Bank policy with respect to its fundamental role regarding rural finance. For almost two decades the Central Bank had employed an aggressive policy of allocating financial resources towards the agricultural sector. To accomplish this goal, it stimulated the growth of Rural Banks, subsidized agricultural loans, employed quotas to expand rural lending of the banking system, offered rediscounting to expand the liquidity of banks making approved agricultural loans, and engaged in detailed management of lending to farmers and the operations of the Rural Banks. These policies were given major importance with the rice shortages of the early 1970s in the form of Masagana 99, but were subsequently expanded into a variety of targeted lending programs. Although this strategy may have contributed to an expansion in agricultural output, the costs have been high[2]. It undermined the Rural Banks, the very institutions it was designed to help by destroying their incentives to engage in sound rural financial intermediation, and saddled many of them with a large portfolio of uncollected loans[3]. Several of the bigger institutions avoided these problems and the agricultural loan quotas, however, by

---

[2]Sacay, Agabin and Tanchoco summarize some of the evidence about the extent to which Masagana 99 really contributed to expanding rice production.

[3]Many banks contributed to their own problems, of course, by eagerly participating in the strategy.

choosing the alternative of investing in government obligations rather than expanding loans, thereby thwarting the intended policy but preserving their financial integrity. The strategy destroyed the credit ratings of thousands of Filipino farmers who to this day have not repaid the loans they were encouraged to take during this period, and created the bad precedence of suggesting that government directed loans could be treated as grants rather than loans to be repaid.

The Central Bank is now moving away from a resource allocation role and is assuming more of the traditional central bank role of managing the money supply, controlling inflation and assuring the public of the safety and stability of the financial system[4]. Interest rate controls have been relaxed to create more incentives to lend, and market forces are intended to be used to establish interest rate levels. Several government agencies are funding guarantee programs to reduce the lenders' perception of the riskiness of lending to certain clientele. A major related change was the creation of the Comprehensive Agricultural Loan Fund (CALF) which merged twenty out of the forty-six separate loan funds for the commodity programs previously implemented by the Department of Agriculture. CALF funds are now being used to guarantee loans made under four programs: Philippine Crop Insurance Corporation, Guarantee Fund of Small and Medium Enterprises, Quedan Guarantee Fund Board, and Bagong Pagkain ng Bayan (guarantee funds for loans to

[4]Another major role of the Central Bank beyond the scope of this paper is the management of the country's large foreign debt.

local government units). Although there are pressures to reduce interest rates and expand credit supplies for priority sectors, including agriculture, the Central Bank is no longer viewed as the agency to advocate these policies nor implement them through financial policies. The significance of this fundamental change should not be overlooked as we discuss the large number of things that still remain to be done to develop rural financial markets.

Another major development in rural finance was the introduction of the Rural Bank Rehabilitation Program after years of discussion about what to do with the Rural Banks that failed or were failing because they could not service the debts incurred through participation in past government credit programs. ACPC data show that as of December 31, 1988, 522 banks had applied for participation and 476 had been approved. Of the approved banks, 295 had fully complied with program requirements and 53 had partially complied. With the infusion of additional equity capital, these banks should be on the road to recovery and should resume providing financial services in their local market areas. With appropriate training and supervision, the problems which caused their downfall should be avoided in the future.

Planned Financial Reforms

The recently signed Letter of Intent with the IMF suggests that a number of additional reforms will be implemented to further deregulate and strengthen the financial system which will have implications for rural financial markets. These include:

1. Strengthen the legal framework for bank supervision.
2. Improve depositor protection by enlarging the role and strengthening the Philippines Deposit Insurance Corporation (PDIC).
3. Improve competition in banking including removing restrictions on the opening of new rural branches by qualified institutions.
4. Reduce intermediation costs by phasing out over the medium term the 20 percent withholding tax on interest income of financial savings and the gross receipts tax on financial institutions.
5. Continue transferring responsibility for supervising most agricultural credit programs to the Department of Agriculture, including the transfer of the World Bank and AID-funded Agricultural Loan Fund.
6. Continue the policy of establishing market-oriented interest rates for government-sponsored credit programs.

If these changes are in fact implemented, they will help contribute to a favorable environment in which rural financial markets can develop.

REMAINING ISSUES

The discussion above suggested that several major developments either already implemented or planned will remove the primary remaining obstacles preventing the development of rural financial markets. There are several reasons, however, that make us less sanguine that the essential preconditions are in place. The recent "rice crisis" provides a good example of just how quickly the clock could be turned back on policy reform. The emergency importation of rice and the demand for the introduction of price controls on key commodities may be an appropriate short-term response to a crisis affecting the most important item in the consumer consumption basket, especially of low income households. However, experience in other countries shows how difficult it is to remove interventions that reduce food prices and allow the market to once again determine price levels. Yet it may be that higher prices are eventually needed to stimulate the investments that will lead to long-term food security. And higher rice prices may be essential if small rice farmers are to become attractive customers for financial institutions. Furthermore, there were some suggestions during the crisis that the country needed another subsidized Masagana 99-type program to spur rice production. Thus it appears that the disastrous lessons of the past are not universally understood and that sound rural financial policies may be subordinate to low rice prices. This experience also suggests that the country's rural development-led economic strategy could be easily sabotaged if it fails to meet the short-term food needs of vocal urban interests.

Another recent development with great implications for rural financial markets was the enactment of the Comprehensive Agrarian Reform Program(CARP). It represents many potential opportunities and challenges for the financial system[5]. On the one hand, demands are being made that agrarian reform beneficiaries should be granted loans and, in fact, the program could result in many potential new customers for banking services. This raises the question of the appropriate retail and/or combination of wholesale/retail arrangements to meet this demand. On the other hand, there are serious questions about the capacity and willingness of the financial system to supply these services. Generally, agrarian reform beneficiaries are considered to be poor credit risks. Their repayment records have been poor. They have collateral problems because the land they receive is already mortgaged for the amortization payments. Politically it may be difficult to take legal action against this class of borrowers if they default. Uncertainty about the sequencing of reform, possible exempted areas or enterprises, retention limits, valuation of land currently mortgaged for loans, etc. may discourage lenders, and there seems to be some evidence that some have already begun to demand urban land as collateral for agricultural loans.

The balance of this section includes a discussion of several specific issues that demand attention because of their impact on the future development of rural financial markets.

---

[5]Several issues concerning the financing of agrarian reform were discussed in papers presented at the workshop-conference on "Credit and the CARP" held March 2-3,1989 at the Central Bank.

Rural Banks and their Rehabilitation

The Rural Banks will play an important role in determining the extent to which formal institutions can serve the financial needs of rural households, especially small farmers, the landless, and the poor. Because they are small, are located close to rural residents, and have easier access to their customers, the Rural Banks have a potential advantage over other types of financial institutions. As such they may be able to incorporate into their lending decisions factors other than loan collateral in the form of physical assets. A rural banker, who had spent all her life in the rural town where her bank is located, recently revealed that she knew all 10,000 farm borrowers and 500 nonfarm borrowers of her bank. Although this may be an unusual case, it demonstrates the information advantage that a rural banker can have compared to the manager of a larger institution who may be from outside the community and may be transferred to a new branch every few years.

Unfortunately, the situation of and prospects for the Rural Banks are quite unclear for several reasons. The traditional wisdom is that the strong Rural Banks were founded before the advent of government-directed lending programs or were able to avoid the pressure to participate in them. There is some empirical evidence to support that claim. But it is not clear if the new terms and conditions for agricultural lending are adequate to stimulate them to aggressively make farm loans. In spite of the guarantee programs, there is still great concern about the riskiness of agriculture. The fact remains that a large proportion of the agricultural population is poor in both assets and income, and by definition has a limited capacity to borrow and pay back large loans. Therefore, access to loans is likely to occur through a slow build-up of confidence with a banker that will develop through, first, a deposit relationship followed by borrowing and successfully repaying a small loan. Deposit services are, therefore, the most crucial service that a banker can offer if formal loans are to become available to the poor. Helping Rural Banks develop cost-effective methods to mobilize and manage a large number of small deposit accounts is still a need. Current experiments with microcomputers may suggest ways to reduce the administrative cost of these accounts. Attention is also required to the need to provide real rates of return to depositors in an environment in which inflationary expectations are rising.

There have been few new Rural Banks licensed in recent years. The negative economic climate in rural areas has obviously constrained the demand for licenses. But it also appears that the Central Bank has been overly concerned in its licensing policy about excessive competition in local markets. The acquisition of a few failed banks by stronger ones may have been an effective way of helping resolve the failed bank problem, but at the expense of reducing competition. The situation today is that about half of the municipios in the country do not have even one banking office. This hardly represents overbanking. In the new climate of deregulation and competition, it is important to facilitate the opening of new branches and the licensing of more Rural Banks. Competition among banks is needed in order to stimulate the supply of a greater variety of financial services and drive down the costs of these services in rural areas. Central Bank policies need to be reviewed on this important matter. The decision to open a bank or branch should rest heavily on the profit calculations of the banking entrepreneurs who are prepared to risk their capital on the venture. The availability of expanded insurance to protect depositors should encourage the Central Bank to license more rural banks and branches, and let more of the risk of overbanking rest with the bankers[6].

It is too early to determine if the Rehabilitation Program is having the desired effects. The large number of banks utilizing it suggests it is providing them with a way out of their difficult problems. The long-term issue is whether or not this new opportunity will permit them to actually strengthen themselves. A recent conversation with a banker in the Program from Pangasinan suggests that deposit mobilization and loan collection drives are having good results in improving the viability of the bank. A monitoring program needs to be put in place to determine if this positive result is being experienced elsewhere. The recent request by bankers to stretch out or restructure their obligations suggests that they are still trying to negotiate a better set of terms rather than get on with the business of rural intermediation. The worst thing that could happen to the Program now would be for

---

[6]ACPC presented an analysis of rural banking issues in "Bank Entry and Expansion and the Availability of Banking Services".

additional easy money to be dumped into the banks before careful deposit mobilization and lending programs are put in place.

The supervisory roles of the Central Bank and PDIC will be crucial in preventing Rural Bank failure in the future. Their role in this important function will need to be strengthened. The procedures used to identify weaknesses in banks early enough so corrective action can be taken will also need to be reviewed. The recent two studies on bank early warning models by Llanto and Vergara represent the type of analysis that is needed.

The Expanded Role of the Land Bank of the Philippines

No rural financial institution has undergone more change in orientation in the past year or so than the Land Bank. During its history, it avoided the financial problems encountered by other rural lenders by limiting its exposure in agriculture and making sufficient income from nonagricultural activities to subsidize the potential high losses arising from a large portfolio of overdue agrarian reform loans. Besides the need to resolve these problem loans, the Land Bank has begun to help rehabilitate some of the Rural Banks, implement a much expanded agrarian reform, and administer other government lending programs. It is in the process of a major expansion in new staff and field offices to handle these tasks. There are also proposals to turn the Land Bank into an apex bank for agriculture. Recognizing its limitations as a credit retailer, it is encouraging farmers to form groups and cooperatives in order to jointly borrow from the Bank. It is also working with Rural Banks by participating in the financing of large farm loans and in developing liquidity funds to help participating Rural Banks in periods of financial stress.

Several observations have been made about the wisdom and implications of the Land Bank assuming these major added responsibilities[7]. One is that it is useful to have government programs concentrated in one strong financial institution[8] that has the integrity to demand financial discipline and that will require that subsidies be made explicit and transparent. Another is that even a strong institution like the Land Bank is over-extending itself and will not be able to provide quality service in all the areas in which it is becoming involved. Yet another view is that the Bank has not solved the problem of financing past agrarian reform beneficiaries on a viable basis and is likely to permit the spread of loan delinquency and default to the CARP beneficiaries. An even more negative view is that the formation of farmer groups to receive loans will result in the repetition of the previous bad group lending experience in the Philippines in which group dynamics as frequently led to group nonrepayment as to repayment. It is further argued that the Bank will eventually succumb to pressure and become an easy rediscount window for participating Rural and other banks. Furthermore, a bad repayment record by agrarian

---

[7]Some of these issues were discussed in the workshop-conference on "Credit and the CARP" and in the paper by Kern, et.al.

[8]As evidence that the Land Bank is perceived as a strong institution, the Department of Agriculture recently selected it to implement the Integrated Rural Financing Program(IRF).

reform beneficiaries could "contaminate" other rural borrowers so good banks would reduce their agricultural portfolios and leave the sector worse off than it is today.

A careful research program needs to be mounted to assess these issues and contribute to policy formation so that the sad rural finance experience of the past will not be repeated. This research will also help identify the reasons why lenders are hesitant to lend to agrarian reform beneficiaries.

Informal Finance

Traditionally, the informal financial sector has not been viewed as playing a positive role in providing financial services. That perspective is being challenged because of the recent research reports prepared by Adams and Sandoval, Agabin, et.al., Armenia, Floro, Geron, Lamberte, Larson and others. These reports show the wide variety of informal financial arrangements that exist, the large number of households that utilize informal finance, the complex set of reasons for utilizing these services, and the difficulty that exists in concluding whether or not informal finance represents an important service to be nurtured or an undesirable substitute for formal finance that will disappear when the formal system improves and penetrates further into rural areas.

The significance of the informal sector in rural areas was once again revealed in the preliminary results of a recent careful ACPC survey of 4 villages in Nueva Ecija in which 171 sampled households were interviewed regarding the wet and dry seasons of

1987/88. Unlike many agricultural studies, this survey included both farm and nonfarm households. Of the total sample, 140 households reported borrowing in one or both seasons and they reported a total of 597 loan contracts. Only 30 (5%) contracts were with banks and cooperatives, and only 14 involved mortgaging cultivation rights as collateral. Traders were the most important source of the 567 informal contracts, followed in importance by landowners. Just under half (248) of the total contracts were between persons considered friends and relatives.

Whether or not because of need or greater ingenuity, the informal sector is succeeding in providing loans to rural households on a scale that the formal sector cannot match. All too frequently, however, the objective of financial policy has been to expand the formal system and impose its standard norms and procedures on a rural economic and social system that may be quite inhospitable at this stage of development. The most obvious problem is that formal finance relies heavily on loan collateral to screen customers and reduce the probability of loan loss. Land is by far the most readily accepted collateral in any rural financial system in the world. Yet a significant proportion of rural residents in the Philippines are landless, and a large proportion of farmers rent all or most of the land they operate. Guarantee programs and other forms of collateral substitutes acceptable to formal finance have not been universally successful in resolving the problem. Yet the informal sector finds a way to successfully provide financial services in spite of this problem. This suggests that the informal system has some advantages that need to be better understood. Perhaps some of these advantages can be adopted or mimicked by the formal system, or perhaps the formal system in its current form will always be stunted and operate at a disadvantage until the appropriate environment is in place. In the meantime, it is important that financial policies are not pursued with the objective of eliminating informal finance.

The researchers who are trying to improve our understanding of informal finance and the implications for financial policy need to be given as much support and encouragement in their challenging task as the researchers of the formal system. They face the additional problem that the data they need is most difficult and expensive to obtain and the methodologies for analysis are not as well developed.

Rural Nonfarm Enterprises

Most of the attention on rural finance in the Philippines is directed toward agricultural credit, and most specifically toward production credit for farmers. There is little recognition of the fact that the success of agriculture is often directly tied to the performance of many types of nonfarm enterprises located in rural areas. These enterprises provide inputs and services essential to farm production and they process and market that production. In the process, they furnish primary or secondary employment to members of farm households, particularly for landless households. This employment occurs on farms as household members engage in handicraft and other activities during periods of slack labor demand for farm enterprises. Employment also occurs off the farm as household members hire out their labor on neighboring farms and in villages and small towns (Llanto, Villegas, and Octavio).

The financial characteristics and needs of rural nonfarm enterprises are not well understood. In some cases, these enterprises undoubtedly generate income that is used to finance consumption and production inputs on farms. In this way, they augment household liquidity and serve as substitutes for borrowing. In other cases, these enterprises require their own operating capital so that loans provided by formal and informal sources help lubricate their production activities and expand their output.

Because of the fungibility of funds, it is likely that loans provided to farm households for agricultural production have helped finance their nonfarm enterprises. Some loan funds have undoubtedly substituted for a household's own funds which have then been diverted to nonfarm enterprises. When loans are targeted only for agricultural enterprises, however, it is more difficult for entrepreneurs to finance nonfarm enterprises which may generate a higher rate of return. There is always some risk of detection if funds are diverted to purposes other than intended so entrepreneurs engage in unproductive activities to cover up the actual use of loans.

The needs of and opportunities for providing financial services to nonfarm enterprises must become part of policymaker concerns about rural financial market policy[9]. Rural financial institutions need to be assisted to understand the role that nonfarm enterprises play in the farm household, their contribution to household cash flow, and therefore their importance in improving household creditworthiness. These enterprises also offer financial institutions new opportunities for savings mobilization and for diversification of loan portfolios. By providing services to these enterprises, they will indirectly support the agricultural sector.

CONCLUSION

This paper summarized many recent key developments affecting rural financial markets in the Philippines, and identified several important issues requiring additional attention. These include the Rural Banks and their rehabilitation, the sharply expanded rural financial role being assumed by the Land Bank of the Philippines, the significant role of informal finance in rural areas, and the need for more attention to the needs of and opportunities for financal services for rural nonfarm enterprises. In addition, it was noted that the recent rice crisis shows how quickly financial reforms could be undercut, and how CARP has at once created increased opportunities for rural lending and increased risks and uncertainty for rural lenders.

[9]The current review of government livelihood programs provides an opportunity to assess the appropriate strategy for use in stimulating rural nonfarm enterprises.

There is no question that policy changes during the past few years have created a better environment in the Philippines for developing viable, self-sustaining rural financial markets. But there are also many pressures to revert to past policies of subsidizing interest rates and targeting loans in order to meet the interests and needs of particular groups. To preserve and extend the benefits of financial reform requires a strong program of rural finance research, plus an equally strong program of education to help policymakers appreciate the danger of adopting policies that on the surface appear to meet short-term needs, but of implemented would in effect undo much of the progress achieved in recent reforms.

References

Adams, Dale W, and Virginia Sandoval, "Informal Finance in Rural Areas of the Philippines," Dept. of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio, March, 1989, ESO #1570.

Agabin, Meliza H., et. al., "Studies on the Informal Credit Markets in the Philippines: An Integrative Report," PIDS Working Paper No. 89-12, February, 1989.

Agricultural Credit Policy Council, "Bank Entry and Expansion and the Availability of Banking Services," Unpublished paper, September 1988.

Armenia, Pedro T., "Analysis of Informal Credit Arrangements in Eastern Visayas, Philippines," Final Report, UP Los Banos Agricultural Policy Research Program, 1988.

Floro, Sagrario L., "Technical Change and the Structure of Informal Credit Markets," Dept. of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio, May 1987, ESO #1352.

Geron, Ma. Piedad S., "Philippine Informal Rural Credit Markets: Efficiency and Equity Issues," Final Report, UP Los Banos Agricultural Policy Research Program, 1988.

Kern, James R., Rolf F. H. Bolt, and Danilo Cruz-Depaula, "Independent Assessment of the August 1987 Apex CFI Feasibility Study," Prepared for USAID, Manila, Philippines, March 1989.

Lamberte, Mario B., "The Role and Performance of Cooperative Credit Unions in the Rural Financial Markets: Some Preliminary Results," Paper presented at the ACPC-PIDS-OSU Seminar Workshop on "Financial Intermediation in the Rural Sector: Research Results and Policy Issues," September 26-27, 1988, Central Bank, Manila, Philippines.

Larson, Donald W., "Marketing and Credit Linkages: The Case of Corn Traders in the Southern Philippines," Dept. of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio, December, 1988, ESO #1539.

Llanto, Gilberto M., Pablito M. Villegas, and Generoso G. Octavio, "Credit Delivery to Philippine Rural Enterprises: Issues and Policy Framework," Dept. of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio, October, 1988, ESO #1522.

Llanto, Gilberto M., "Identifying Problem Banks Using Statistical Methods," Draft ACPC Paper, Manila, Philippines, 1989.

Meyer, Richard L., "Rural Finance in the Philippines: Recent Changes and Priority Issues," Dept. of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio, June 1987, ESO #1358.

Sacay, Orlando J., Meliza H. Agabin and Chita Irene E. Tonchoco, Small Farmer Credit Dilemma, Technical Board for Agricultural Credit, Manila, Philippines, 1985.

Vergara, Severino B., "Multiple Discriminant Analysis of Rural Bank Performance," Final Report, UP Los Banos Agricultural Policy Research Program, 1988.